

October 5<sup>th</sup>, 2018

Mr. Christopher Kirkpatrick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

**Re: Exemption from Derivatives Clearing Organization Registration (RIN 3038-AE65)**

Dear Mr. Kirkpatrick:

**I. Introduction**

On behalf of Japan Securities Clearing Corporation (“**JSCC**”), I would appreciate the opportunity to submit our views on the proposed rules of the Commodity Futures Trading Commission (“**Commission**” or “**CFTC**”) with respect to the “Exemption from Derivatives Clearing Organization Registration”, RIN number 3038-AE 65.

JSCC was established on July 2002, and was licensed in Japan as the first clearing organization to conduct a “Securities Obligation Assumption Service”<sup>1</sup> in January 2003, and started clearing services for transactions executed on Japanese stock exchanges.

In addition to listed products, such as cash equities, futures and options, JSCC also provides clearing services for OTC derivatives (Credit Default Swaps (“**CDS**”) and Interest Rate Swaps (“**IRS**”)) and OTC Japanese Government Bond transactions. JSCC received an Order of Exemption from Registration from the Commission pursuant to Section 5b(h) of the Commodity Exchange Act (“**CEA**”) in October 2015 in order to provide clearing services for IRS for (i) a U.S. person<sup>2</sup> that is a clearing member of JSCC clearing for itself and for those persons identified in the Commission's definition of "proprietary account" set forth in Regulation 1.3(y); (ii) a non-U.S. person that is a clearing member of JSCC clearing for any affiliated U.S. person identified in the definition of

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<sup>1</sup> Currently this is termed as “Financial Instrument Obligation Assumption Service” in the Financial Instruments Exchange Act, meaning clearing service by central counterparties.

<sup>2</sup> U.S. Person is an entity which falls under the definition of “U.S. person” as set forth in the Commission’s Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45292, 45316–17 (July 26, 2013).

"proprietary account" set forth in Regulation 1.3(y); and (iii) an entity that is registered with the Commission as an FCM clearing for itself and those persons identified in the definition of "proprietary account" set forth in Regulation 1.3(y). An amended order was issued by the Commission in May 2017 to permit JSCC to offer clearing services for all swaps, including CDS, to those identified above<sup>3</sup>.

## II. Opinion to the public consultation

JSCC generally supports the CFTC's efforts to codify the existing regulatory framework for exempting clearinghouses from the DCO registration requirements. This effort would greatly enhance the transparency and the certainty on the status of an exempt DCO. In addition, we fully agree with the CFTC's policy to deem a supervisory and regulatory framework that conforms to the Principles for Financial Market Infrastructures ("PFMIs")<sup>4</sup> to be comparable to, and as comprehensive as, the supervisory and regulatory requirements applicable to registered DCOs.

JSCC would like to congratulate Chairman Giancarlo on the forward-thinking and balanced proposals laid out in his September 4th speech<sup>5</sup> and a white paper titled "CROSS-BORDER SWAPS REGULATION VERSION 2.0"<sup>6</sup>. JSCC believes the proposals would represent a ground-breaking step forward in terms of the CFTC's international regulatory cooperation, and for the global regulatory framework, by increasing regulatory harmonization.

JSCC fully supports the proposed expansion of the CFTC's exemptive authority for non-U.S. CCPs that clear swaps and that do not pose substantial risk to the U.S. financial system, if the CCPs are subject to "comparable, comprehensive supervision and regulation" in their home country, with a view to permitting such non-U.S. CCPs to provide clearing services to U.S. customers indirectly through non-U.S. clearing members, without the requirements for the non-U.S. CCP and its non-U.S. clearing members to register as a DCO or FCMs, respectively.

As described in greater detail below, JSCC welcomes the opportunity to provide comments on the proposed amendments to the CFTC Regulation Part 39 and to respond to the specific questions posed by the Commission in the adopting release to the proposed rule.

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<sup>3</sup> Currently JSCC's CDS clearing service is only provided to clearing members and their affiliates.

<sup>4</sup> CPMI-IOSCO, Principles for financial market infrastructures (Apr. 2012)  
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377-PFMI.pdf>

<sup>5</sup> [https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo52?utm\\_source=govdelivery](https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo52?utm_source=govdelivery)

<sup>6</sup> <https://www.cftc.gov/PressRoom/PressReleases/7817-18>

**a. Clearing for a U.S. customer and the Commodity Exchange Act / U.S. Bankruptcy Code**

*Proposed Regulation 39.6(b)(1) would have the effect of prohibiting the clearing of FCM customer positions at an exempt DCO. The CFTC states the reason for this restriction as: “Absent that chain of registration, the swaps customer’s funds may not be treated as customer property under the U.S. Bankruptcy Code and the Commission’s regulations.”<sup>7</sup> In its request for comments, the CFTC asks whether the CFTC should “consider permitting an exempt DCO to clear swaps for FCM customers”<sup>8</sup>.*

JSCC believes that any restrictions placed on the access for U.S. customers<sup>9</sup> to swap clearing services at exempt DCOs have become increasingly problematic, as clearing mandates have shifted liquidity into central clearing, and more entities are incentivised to clear OTC derivatives due to (i) global margin rules applied to uncleared OTC derivatives, (ii) the benefits of netting, and (iii) the reduced capital requirements for CCP exposures under the Basel III framework, as evidenced in recent research by the Financial Stability Board<sup>10</sup>. This situation would be further exacerbated for U.S. customers that are subject to the CFTC’s clearing mandate, which includes IRS denominated in non-USD currencies such as Japanese Yen (“JPY”).

It would be natural for market participants to seek to execute a given transaction in the venue with the highest liquidity and the best available prices, and where the safest clearing arrangements for that transaction are offered. In most cases, that would be the home country of the currency relevant to the swap transaction – i.e., Japan for the trading and clearing of JPY-denominated derivative transactions. Indeed, JSCC has been providing JPY-denominated IRS clearing services for a wide range of cross-border transactions<sup>11</sup>, with the exception of those executed by U.S. customers.

<sup>7</sup> Exemption From Derivatives Clearing Organization Registration, 83 FR 39926 (Aug. 13,2018)

<sup>8</sup> Exemption From Derivatives Clearing Organization Registration, 83 FR 39930 (Aug. 13,2018) (“IV. Request for Comments”)

<sup>9</sup> This refers to any entity clearing in an exempt DCO which is neither a clearing member nor its affiliate, and which falls under the definition of a “U.S. person” as set forth in the Commission’s Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45292, 45316–17 (July 26, 2013).

<sup>10</sup> See “Incentives to centrally clear over-the-counter (OTC) derivatives, A post-implementation evaluation of the effects of the G20 financial regulatory reforms” (7 August 2018), Part A Executive summary.  
<http://www.fsb.org/wp-content/uploads/P070818.pdf>

<sup>11</sup> JSCC has obtained a regulatory status in the EU, Australia, Hong Kong, and Switzerland, to provide its

Additionally, we believe that it would be beneficial to allow U.S. customers to access the widest possible range of DCOs, as this would encourage the voluntary clearing of swaps that are not mandated for clearing, allowing U.S. customers to diversify their risks, rather than concentrating their clearing in a limited number of DCOs.

In our view, the current U.S. regulatory framework prevents U.S. customers from enjoying these benefits. JSCC has identified two main issues that prevent U.S. customers from accessing exempt DCOs:

Firstly, there are often very few FCM-registered clearing members in exempt DCOs. However, an exempt DCO's clearing members would be properly regulated, supervised, and licensed in their relevant home countries to provide swap clearing services for customers. Although, the relevant home country regulatory authorities of clearing members may have established cooperative arrangements with the CFTC, as is required for the home country regulator of an exempt DCO, clearing members may be unable to register as an FCM, due to various legal and regulatory conflicts, in addition to the cost associated with FCM registration. For example, a non-U.S. FCM is required to ensure that a swap customer's collateral is treated in accordance with the U.S. Bankruptcy Code, as required by the CEA and the CFTC Regulation Part 22, even in the case of the default of a non-U.S. FCM where the home country's bankruptcy law would be applied. In fact, very few non-U.S. FCMs are registered with the CFTC<sup>12</sup>, and the number of FCMs has decreased over the years<sup>13</sup>. Indeed to support client portability in the event of a clearing member default, an exempt DCO would need to maintain multiple FCM clearing members, which is very challenging for *any* non-U.S. CCP. As non-FCMs are not permitted to clear for U.S. customers, regardless of such customer's country of incorporation<sup>14</sup>, this lack of non-US FCMs will continue to restrict access for U.S. customers to the swap clearing services of exempt DCOs.

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JPY IRS clearing service for person located and domiciled in those jurisdictions:

<https://www.jpx.co.jp/jsccl/en/company/regulatory-status.html>

<sup>12</sup> According to the website of NFA, as of August 22<sup>nd</sup> 2018 there were four non-U.S. FCMs registered with the CFTC.

<https://www.nfa.futures.org/registration-membership/membership-and-directories.html>

<sup>13</sup> See "Incentives to centrally clear over-the-counter (OTC) derivatives, A post-implementation evaluation of the effects of the G20 financial regulatory reforms" (7 August 2018), Figure C.10 Historical count of Futures Commission Merchants (FCMs).

<http://www.fsb.org/wp-content/uploads/P070818.pdf>

<sup>14</sup> The definition of a U.S. Person in the CFTC's interpretive guidance includes an entity incorporated outside of U.S. in some cases. Therefore, even a legal entity incorporated in Japan may be deemed as a U.S. Person in the guidance.

Secondly, it would not be practicable for an exempt DCO to establish a system to ensure the application of the U.S. Bankruptcy Code. Specifically, when an exempt DCO were to declare bankruptcy, a U.S. customer's property would be held in the exempt DCO's home country, subjecting it to the bankruptcy law applicable to the exempt DCO's home country. JSCC maintains robust segregation systems in its CDS and IRS clearing services, under which JSCC utilizes Individually Segregated Accounts to segregate each customer's and affiliate's positions and collateral. JSCC holds customer collateral in a trust account, with the customers as the beneficiary of the trusted assets. Therefore, under Japanese Law these assets are held remotely and protected from the bankruptcy of the clearing members, the trust bank, and JSCC. We understand that JSCC's arrangements are not acceptable to the CFTC, due to the CFTC basing its policy on the U.S. Bankruptcy Code. However, we believe our customer protection system conforms to the relevant PFMI principles, and provides sufficient safety for *any* customer in the jurisdictions where JSCC operates. In other (non-U.S.) foreign jurisdictions where JSCC holds regulatory licenses for its clearing services<sup>15</sup>, JSCC is not required to ensure the application of the foreign jurisdiction's bankruptcy code to customer's collateral.

Therefore, JSCC would like the CFTC to consider the potential benefits of allowing U.S. customers to access exempt DCOs, using a similar approach to the correspondent clearing structure adopted for foreign futures markets, by permitting:

- an exempt DCO, that has implemented PFMI-compliant levels of customer protections, to clear swaps for U.S. customers (including FCM customers); and
- non-U.S. clearing members in an exempt DCO to clear for U.S. customers, without the necessity to register as an FCM, as long as those non-U.S. clearing members can demonstrate that they are properly supervised, regulated, and licensed to provide customer clearing services in their home countries, where the regulatory authority maintains appropriate cooperative arrangements with the CFTC.

#### **b. Reporting on a change in home country regulatory regime**

*Proposed Regulation 39.6(c)(2)(iii) would require an exempt DCO to provide prompt notice to the CFTC regarding any change in its home country regulatory regime that is material to the exempt DCO's continuing observance of the PFMIs, any requirements set forth in proposed Regulation 39.6, or the order of exemption issued by the CFTC. Additionally, the CFTC asks "whether an exempt DCO should make the determination of whether a change to the home country regulatory regime constitutes a material change"*<sup>16</sup>.

<sup>15</sup> The EU, Australia, Hong Kong, and Switzerland.

<sup>16</sup> Exemption From Derivatives Clearing Organization Registration, 83 FR 39928 (Aug. 13,2018)

JSCC supports the Proposed Regulation 39.6(c)(2)(iii). We believe the regulatory changes in the home country of an exempt DCO affecting the exempt DCO's continuing observance of the PFMI, any requirements set forth in proposed Regulation 39.6, or the CFTC's order of exemption, occur infrequently and are easily identifiable, due to familiarity of exempt DCOs with the legal and regulation framework in their home countries. Therefore, to avoid the burden arising from redundant reporting and review for an exempt DCO and the CFTC, the CFTC should maintain the Proposed Regulation 39.6(c)(2)(iii), rather than requiring reporting on any change in the home country regulatory regime.

### c. SDR Reporting

*Proposed Regulation 39.6(d) would require that if a clearing member clears through an exempt DCO a swap that has been reported to a registered swap data repository (SDR) pursuant to part 45 of the CFTC's regulations, the exempt DCO must report to an SDR data regarding the two swaps resulting from the novation of the original swap that had been submitted to the exempt DCO for clearing. Further, in order to avoid duplicative reporting for such transactions, an exempt DCO would be required to have rules that prohibit the part 45 reporting of the two new swaps by the counterparties to the original swap.*

JSCC is pleased to see that the SDR reporting obligations for an exempt DCO will be clearly defined in the CFTC Regulation Part 39. However, counterparties to the original swap would still be required to report to an SDR the cleared transactions arising from the novation of the original swap to an exempt DCO under the CFTC Regulation Part 45, which is in conflict with the proposed Regulation 39.6(d). Currently this conflict is mitigated by the temporary relief provided by the CFTC to swap counterparties<sup>17</sup>. However, this conflict would create a confusion in the understanding on the CFTC's expectation by an exempt DCO and its clearing members.

We hope that the CFTC would provide the proposed regulation of the Part 45, with a view to eliminating such a conflict at an early stage.

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<sup>17</sup> CFTC Letter 18-03 available in the link below:

<https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-03/18-03.pdf>

#### **d. Automatic termination of the exemption**

*The CFTC asks if “any of the conditions imposed on an exempt DCO [should] lead to an automatic termination of the exemption if the condition is not met?”<sup>18</sup>.*

As stated above, the regulatory framework for DCO exemption has successfully mitigated legal and regulatory conflicts pertaining to cross border swap transactions, with the CFTC deferring to a supervisory and regulatory framework of an exempt DCO’s home country.

It is possible that a breach of the exemption conditions could potentially occur due to circumstances that are beyond the control of the exempt DCO. Such breaches may arise due to conflicts created as a result of changes in the legal/regulatory framework either by the CFTC or the exempt DCO’s home country regulator.

The implementation of automatic termination would have a potential systemic impact on market participants, due to the resulting market disruption and legal uncertainty. Therefore, we would oppose any automatic termination framework of a DCO exemption.

However, we would propose that the CFTC and the exempt DCO’s home country regulator should engage in good-faith dialogue to resolve any breach. Of course, the termination of the exemption may be required as a last resort, if the dialogue is not successful in revolving the breach, but it should not be automatically implemented, and appropriate transitional arrangements should be implemented to allow the orderly migration of any impacted users away from the exempt DCO’s clearing services, minimizing the impact of the termination on the wider market.

#### **e. Cost estimate for an application for exemption**

*The CFTC states that “the cost burden to submit Form DCO is approximately \$100,000 per entity, while that for submitting an application for exemption is approximately \$10,500 per entity.”*

We acknowledge that the exempt DCO application process presents a significant cost benefit over the process to apply for registered DCO.

However, due to the complexity of U.S. regulations, we believe the CFTC’s estimate of \$10,500 for an application for exempt DCO substantially underestimates the true costs borne by the applicant.

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<sup>18</sup> Exemption From Derivatives Clearing Organization Registration, 83 FR 39930 (Aug. 13,2018) (“IV. Request for Comments”)

Aside from preparing the application materials, a significant amount of resources are required to understand any legal and/or regulatory implications arising from the DCO exemption, as well as to identify any potential conflicts with the applicant's home country regulatory and supervisory frameworks. This work involves extensive support from the applicant's U.S. legal advisor.

Therefore, we would like to request further breakdown and clarification of the basis of the estimates from the CFTC.

### III. Conclusion

We appreciate the opportunity to provide these comments and we look forward to a discussion with the Commission on our opinions. Should you have any questions about this letter, please do not hesitate to contact Mr. Tetsuo Otashiro, Head of Strategic Planning, at +81-50-3361-0928 or by email to [t-otashiro@jpx.co.jp](mailto:t-otashiro@jpx.co.jp).

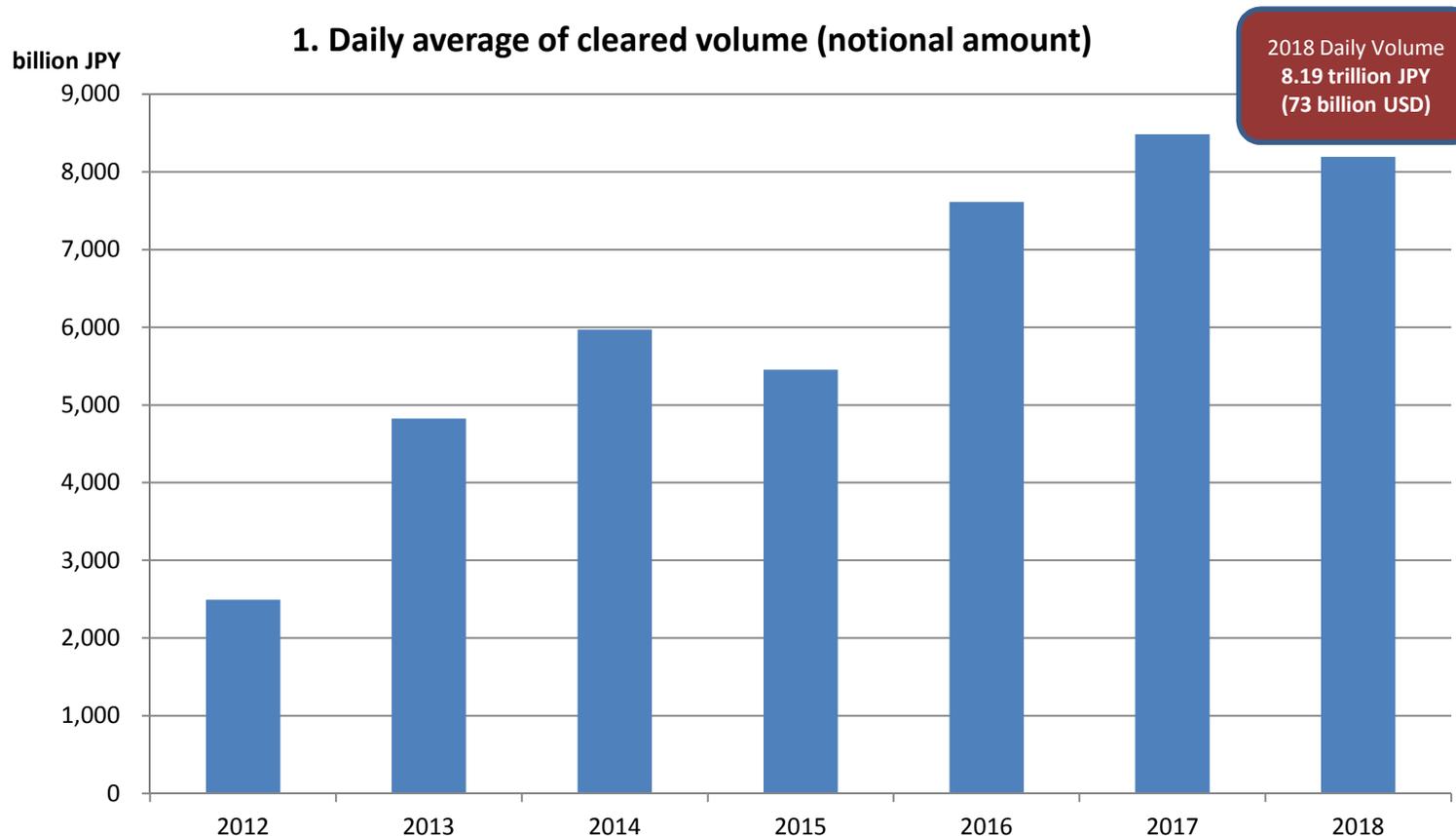
Yours sincerely,



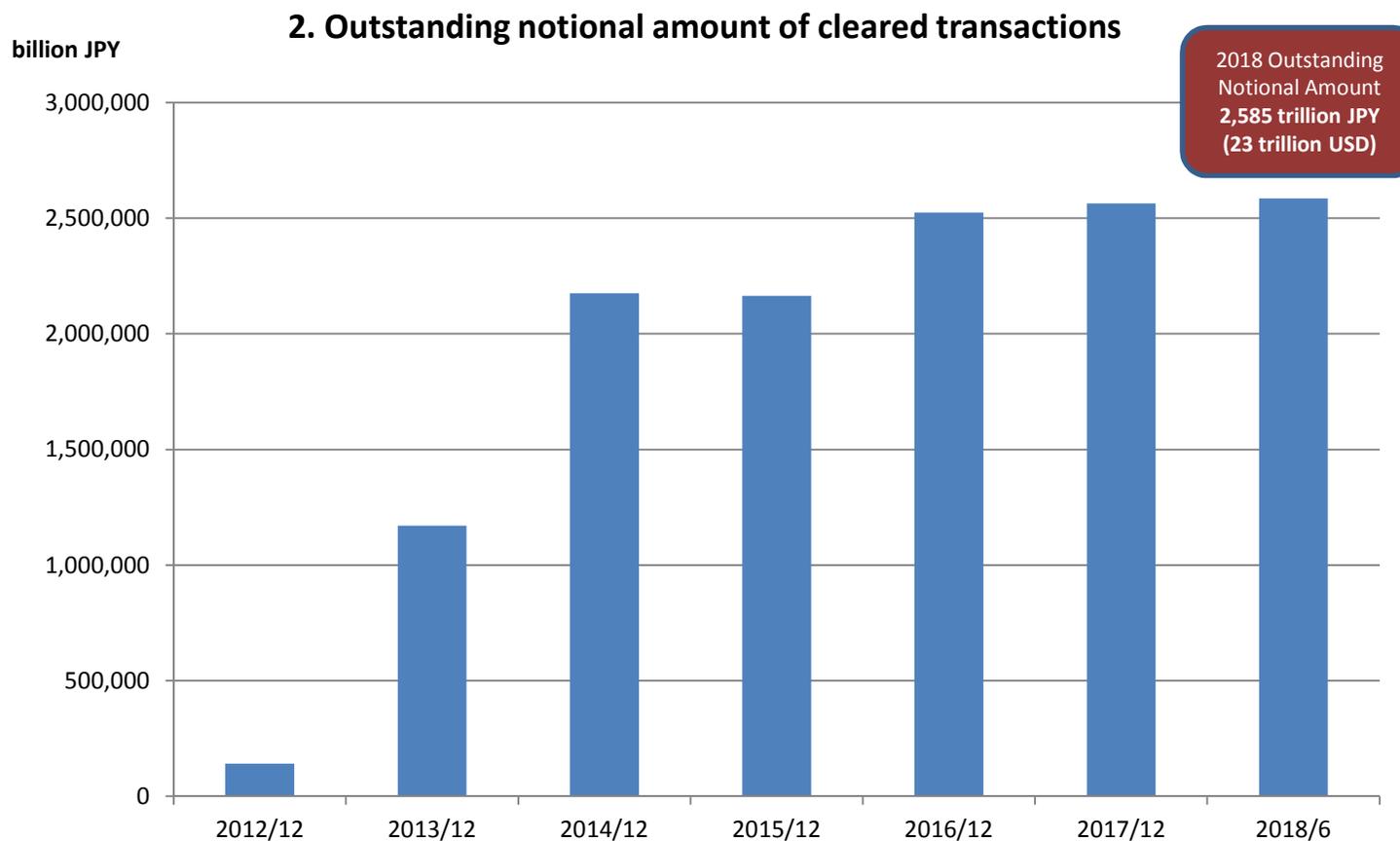
Mr. Hironaga Miyama  
President & CEO, Japan Securities Clearing Corporation

CC: The Honorable J. Christopher Giancarlo, Chairman  
Mr. Mike Gill, Chief of Staff for Chairman Giancarlo  
Mr. Brian A. Bussey, Director, Division of Clearing and Risk  
Mr. Eric J. Pan, Director of the Office of International Affairs

**Profile of Interest Rate Swap Clearing Service by Japan Securities Clearing Corporation**



**Note.** Notional amounts include both legs of a cleared transaction.  
 For 2018, the data provided is for the period from January to June.  
 FX Rate used: 1 USD = 111 JPY.



**Note.** Notional amounts include both legs of a cleared transaction  
 There were no cleared transactions denominated in non-Japanese Yen currencies, as of June 2018.  
 FX Rate used: 1 USD = 111 JPY.